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Grünewald, Seraina

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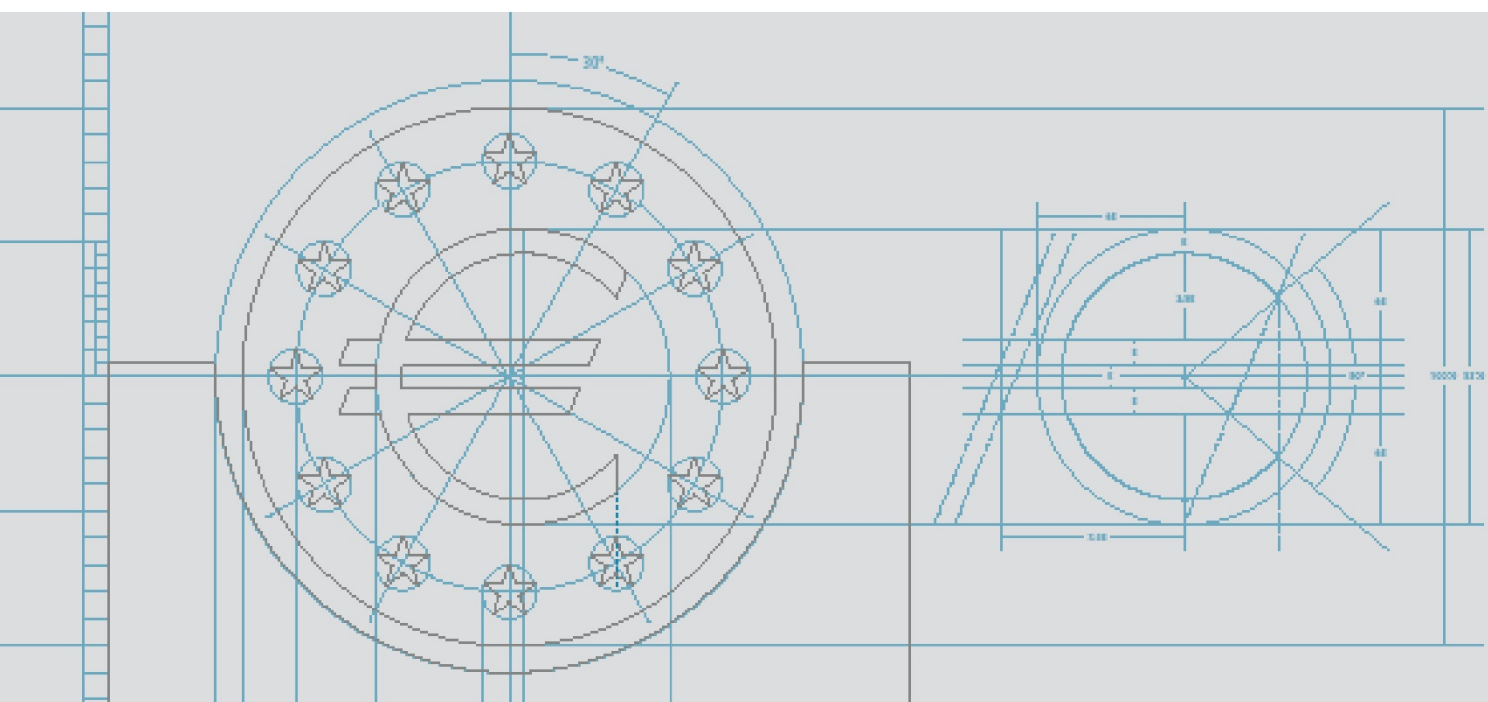


EUROPEAN CENTRAL BANK  
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## ECB Legal Conference 2017

Shaping a new legal order for Europe:  
a tale of crises and opportunities

4-5 September 2017



# Legal challenges of bail-in

By Seraina Grünewald<sup>1</sup>

## 1 History and rationale of bail-in

The history of bail-in is short but eventful. In a 2010 article in *The Economist*,<sup>2</sup> Credit Suisse investment bankers Callelo and Ervin set out a powerful third option to the preceding government bail-outs on the one hand and systemic financial collapse (Lehman) on the other: a forced recapitalisation of failing banks from within. The authors referred to their proposed mechanism as “bail-in”. They argued that authorities should “be given the legal authority to dictate the terms of recapitalisation, subject to an agreed framework.” Based on this authority, failing banks would be restructured in a speedy, regulator-imposed process, using private capital instead of public money.

The Financial Stability Board (FSB) took the idea up, and bail-in became a core element of its Key Attributes of Effective Resolution Regimes for Financial Institutions.<sup>3</sup> The international standard recommends that resolution authorities be given statutory powers to write down equity and uninsured/unsecured creditor claims and/or convert into equity uninsured/unsecured creditor claims to the extent necessary to absorb the bank’s losses. Likewise, bail-in became the “innovative centrepiece”<sup>4</sup> of the European Union’s new resolution framework. The Bank Recovery and Resolution Directive (BRRD)<sup>5</sup> and Regulation on the Single Resolution Mechanism (SRMR)<sup>6</sup> are based on the notion that the costs of a banking crisis must be first and primarily borne by shareholders and creditors and, in certain circumstances, the banking system as a whole.<sup>7</sup> The shift towards privately-funded bank resolution not only followed the international trend, it also became an actual

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<sup>1</sup> Assistant Professor of Financial Market Law at the University of Zurich, Switzerland. The author wishes to thank Concetta Brescia Morra, Anna Gardella, Christos Hadjiemmanuil and Karl-Philipp Wojcik for their comments and suggestions.

<sup>2</sup> Callelo and Ervin (2010).

<sup>3</sup> FSB (2014), paras. 3.5 and 3.6. The original version of the FSB’s Key Attributes dates of 2011.

<sup>4</sup> Wojcik (2016), p. 95.

<sup>5</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

<sup>6</sup> Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1).

<sup>7</sup> The protection of public funds became one objective of the BRRD/SRMR (Article 31(2)(c) BRRD, Article 14(2)(c) SRMR).

“game changer”<sup>8</sup> in the negotiations on banking union, as it alleviated Member States’ fears of heightened fiscal transfers.

Notwithstanding its steep rise, bail-in remains among the most contested elements of new resolution frameworks and the debate on the scope and reasonability of its application continues, both in the Union and internationally. The concerns are at least partially rooted in the intrusive nature of bail-in. In resolution, authorities determine when which creditor must bear which amount of a bank’s losses. They do so based on the principles and objective elements set out in the law, but often with a large interpretative latitude and margin of discretion. As case law and established practices have yet to develop, the resulting challenges are manifold – some clearly legal, some of a more political nature.

This contribution discusses two key legal safeguards of the BRRD that are designed to avoid violations of shareholders’ and creditors’ right to property by bail-in and to guarantee a fair and consistent outcome. The analysis takes up some of the challenges highlighted by recent cases of bank failures involving bail-in in one way or another. It proceeds as follows: Paragraph 2 outlines that bail-in comes in two manifestations: bail-in under the resolution framework of the BRRD/SRMR and burden-sharing under State aid approval proceedings. Paragraph 3 discusses the key features of bail-in that distinguish it from insolvency proceedings and render it a practice that interferes with the right to property as enshrined in the Charter of Fundamental Rights (CFR)<sup>9</sup> and the European Convention on Human Rights (ECHR). The legal challenges associated with the public interest test and “no-creditor-worse-off-than-under-normal-insolvency-proceedings” (NCWO) test of the BRRD are explored in Paragraphs 4 and 5. Paragraph 6 concludes.

## 2 Bail-in (resolution) and burden-sharing (State aid)

Bail-in as a means to limit public financial support to failing banks was not a novelty introduced by the BRRD. Prior to the adoption of the BRRD, the Commission had acted as the *de facto* Union resolution authority and applied a functionally equivalent practice – referred to as “burden-sharing” – in its State aid approval proceedings. According to its 2013 Banking Communication,<sup>10</sup> the Commission requested, in principle, that losses be first absorbed by equity holders, hybrid capital holders and subordinated debt holders before it would approve the grant of any State aid.<sup>11</sup> However, it explicitly excluded from the burden-sharing requirement any mandatory contributions by *senior* debt holders.<sup>12</sup>

The treatment of senior creditors has remained the crucial discrepancy between burden-sharing under the State aid regime on the one hand and bail-in in resolution

<sup>8</sup> Quaglia and Spendzharova (2017), p. 13.

<sup>9</sup> OJ C 364, 18.12.2000, p. 1.

<sup>10</sup> Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (OJ C 216, 30.7.2013, p. 1).

<sup>11</sup> See 2013 Banking Communication, paras. 40-46.

<sup>12</sup> See 2013 Banking Communication, para. 42.

as introduced by the BRRD on the other. With the adoption of the BRRD, bail-in became a resolution tool, i.e. a technique applied by resolution authorities – either on a stand-alone basis or in combination with other resolution tools – to resolve a failing bank.<sup>13</sup> As such, it is defined as “the mechanism for effecting the exercise by a resolution authority of the write-down and conversion powers in relation to liabilities of an institution under resolution (...).”<sup>14</sup> Bail-in is, however, much more than that. It continues to serve as a precondition to any form of official financial support, effectively determining how the burden is to be distributed between the private and official sectors.<sup>15</sup> The BRRD/SRMR go beyond the burden-sharing requirement imposed by the 2013 Banking Communication. They provide for a mandatory preliminary bail-in of at least 8% of total liabilities before resolution financing arrangements or any other source of official financing can be tapped to cover further losses.<sup>16</sup> No such absolute bail-in rule exists under the State aid framework. Bail-in and burden-sharing are thus functional equivalents but differ in terms of their scope of application.<sup>17</sup>

The interrelation of the State aid and BRRD/SRMR frameworks is not entirely settled.<sup>18</sup> As a rule, the use of State aid now triggers resolution and the (stricter) bail-in requirement will typically supersede the burden-sharing requirement associated with the grant of State aid.<sup>19</sup> However, the burden-sharing requirement still takes exclusive effect if a bank is instead liquidated in normal (national) insolvency proceedings (liquidation aid)<sup>20</sup> or if the BRRD exception of a “precautionary recapitalisation” applies.<sup>21</sup>

<sup>13</sup> Articles 43-55 BRRD, Article 27 SRMR.

<sup>14</sup> Article 2(1)(57) BRRD, Article 3(1)(33) SRMR.

<sup>15</sup> See Grünewald (2014), pp. 52-60, distinguishing three levels of burden-sharing: (i) among private creditors; (ii) between private creditors and official sources; and (iii) among Member States. Gardella (2015b) distinguishes a vertical and a horizontal dimension of burden-sharing.

<sup>16</sup> Article 37(10)(a) and Article 44(5)(a) BRRD, Article 27(7)(a) SRMR.

<sup>17</sup> Merler (2017) and (2016) suggests that the precautionary recapitalisation of Monte dei Paschi di Siena (MPS) and the “compulsory administrative liquidation” of Veneto Banca and Banca Popolare di Vicenza (BPVI) were at least partially motivated by authorities’ desire to avoid a bail-in of retail senior bondholders.

<sup>18</sup> For an excellent overview see Gardella (2015a), paras. 11.04-11.21.

<sup>19</sup> A bank is, in principle, deemed “failing or likely to fail” if it requires extraordinary public financial support (Article 32(4)(d) BRRD, Article 18(4)(d) SRMR). Moreover, the Commission must approve the grant of any State aid in the course of a resolution proceeding (see, in particular, Article 34(3) BRRD) and resolution authorities must ensure compatibility with the requirements of the State aid framework (see Article 52(1) and (3) BRRD regarding the business reorganisation plan).

<sup>20</sup> As was illustrated by the case of the two Venetian banks Veneto Banca and BPVI. According to the Commission’s press release (the public version of the decision was not yet available at the time of writing), shareholders and subordinated creditors fully contributed before liquidation aid in the amount of almost EUR 17 billion was authorised (see European Commission, “State aid: Commission approves aid for market exit of Banca Popolare di Vicenza and Veneto Banca under Italian insolvency law, involving sale of some parts to Intesa Sanpaolo”, 25 June 2017, IP/17/1791).

<sup>21</sup> Article 32(4)(d)(iii) BRRD, Article 18(4)(d)(iii) SRMR. On 4 July 2017, the Commission authorised the precautionary recapitalisation of MPS. According to the Commission’s press release (the public version of the decision was not yet available at the time of writing), MPS’s shareholders and subordinated creditors contributed EUR 4.3 billion to the bank’s recapitalisation in consequence of the burden-sharing requirement (see European Commission, “State aid: Commission authorises precautionary recapitalisation of Italian bank Monte dei Paschi di Siena”, 4 July 2017, IP/17/1905).

### 3 How bail-in differs from insolvency and interferes with the right to property

In principle, bail-in is meant to mirror loss absorption in insolvency.<sup>22</sup> Nevertheless, it differs from insolvency in several crucial ways.

#### 3.1 “Failing or likely to fail”: bail-in as a pre-insolvency intervention

The BRRD supersedes the concept of insolvency by what it refers to as “failing or likely to fail” (FOLTF). It is the supervisor (and/or the resolution authority<sup>23</sup>) that determines, in an administrative proceeding, whether a bank meets the FOLTF condition.<sup>24</sup> The BRRD remains rather unspecific regarding the determinants of FOLTF. Article 32(4) BRRD identifies four FOLTF scenarios, which may apply cumulatively or alternatively: (i) the bank infringes or is about to infringe requirements of authorisation to an extent that would justify its withdrawal, including due to a significant capital shortfall; (ii) the bank is or is about to become balance-sheet insolvent; (iii) the bank is or is about to become cash-flow insolvent; and (iv) the bank requires extraordinary public financial support, with a few exceptions. The open wording of Article 32(4) BRRD will make it difficult in practice to identify the point of (the assumed) non-viability. It reflects, however, the intention to enable the authorities to intervene early enough,<sup>25</sup> i.e. *before* actual insolvency. The more likely insolvency becomes, the more of a bank’s value may be destroyed irrecoverably, but the less intrusive is an ensuing bail-in regarding shareholders’ and creditors’ right to property. The question is thus: When is “likely to fail” *likely enough*?

Against this background, FOLTF is nothing less than the extrapolation of a bank’s *future* insolvency beyond reasonable doubt. This extrapolation remains largely an expert judgment, based on the outcomes of the supervisory review and evaluation process (SREP). The expert judgment is, however, guided by a number of “objective elements” set out in the EBA’s guidelines on the interpretation of FOLTF.<sup>26</sup> Because FOLTF determines the “likely” insolvency or the insolvency “in the near future”, many of these objective elements are naturally forward-looking and presumptive themselves.<sup>27</sup>

As a consequence, it is no longer insolvency banks are afraid of under the BRRD/SRM regime. The new reference point for failure is failing an ECB (or other relevant) stress test. If a bank is fine under the baseline scenario, but fails the

<sup>22</sup> See Article 48 BRRD, Article 17 SRMR.

<sup>23</sup> Article 32(2) BRRD allows Member States to empower the resolution authority, under certain circumstances, to carry out the FOLTF assessment in addition to or instead of the supervisor.

<sup>24</sup> In accordance with Article 81(1) BRRD, the management body of a bank must notify the competent authority if it considers the FOLTF condition to be met.

<sup>25</sup> See also Freudenthaler and Lintner (2017), p. 106.

<sup>26</sup> European Banking Authority, Guidelines on the interpretation of different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU, 26 May 2015, EBA/GL/2015/07.

<sup>27</sup> The same is true for the SREP process more generally, which is designed to monitor and assess risks in a forward-looking manner.

adverse scenario, it qualifies for “precautionary recapitalisation”. If the bank fails the baseline scenario, this is a strong indicator for the supervisor to declare a bank as FOLTF. At this point, however, insolvency has not necessarily occurred. It is a point determined by authorities according to their best judgement, on which the design of the underlying stress test has a large influence.<sup>28</sup>

## 3.2 Bail-in as a valuation-based intervention

A second difference between bail-in and insolvency consists in the fact that loss absorption in resolution is based on valuation rather than actual liquidation. The valuation of a bank’s assets and liabilities plays a key role in all different stages of the resolution process.<sup>29</sup> At the request of the supervisory or resolution authority, an independent valuer undertakes mandatory valuations *ex ante* resolution (valuation 1), at the point of resolution (valuation 2) and *ex post* resolution (valuation 3).<sup>30</sup>

- Valuation 1 is aimed at supporting the supervisor’s determination as to whether a bank is FOLTF and should be put under resolution.<sup>31</sup> This initial valuation essentially consists of an updated accounting valuation with regulatory adjustments, as used for ongoing supervision.
- More important regarding loss absorption are valuations 2 and 3: Valuation 2 informs the choice of resolution strategy, including the extent of bail-in. Valuation 3 then provides an estimate on the losses under hypothetical liquidation as the counterfactual benchmark under the NCWO test.<sup>32</sup>

Unlike the realisation of assets in a liquidation, valuation is an estimate, not a fact. Eventually, there will be a factual outcome of every resolution proceeding, but authorities can apply bail-in only based on an estimate of that outcome at the point resolution is triggered. Other crucial parameters remain hypothetical to the very end, such as what the outcome of an insolvency proceeding would have been (valuation 3). In contrast to facts, valuations are necessarily subjective. It will be difficult to find two, let alone several, independent valuers coming to the exact same conclusions as to the estimated extent of losses under a (going-concern) resolution and a hypothetical (gone-concern) insolvency scenario. The subjective nature of the valuations is amplified by their dependency on macroeconomic assumptions and, over time, changing market conditions.<sup>33</sup>

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<sup>28</sup> See Philippon and Salord (2017), p. 43.

<sup>29</sup> The valuation is not subject to a separate right of appeal, but may be appealed together with the resolution decision itself (Article 36(13) BRRD, Article 20(15) SRMR).

<sup>30</sup> On valuation in resolution see Huber (2017), pp. 92-98.

<sup>31</sup> For FOLTF see 3.1 above.

<sup>32</sup> For the NCWO test and more details on the corresponding ex-post valuation (valuation 3) see 5.2.1 below.

<sup>33</sup> Hadjiemmanuil (2015), p. 245.

In *Kotnik and others*,<sup>34</sup> a preliminary ruling on the constitutionality of the Commission's 2013 Banking Communication, the Court of Justice of the European Union (CJEU) did not raise explicit concerns over the writing-down of shares and subordinated debt based on valuation rather than actual liquidation as a consequence of the Commission's burden-sharing requirement. It did, however, assume that the alternative to such valuation-based burden-sharing would be an insolvency proceeding.<sup>35</sup> This brings us right back to the difficulties associated with FOLTF, mentioned above. If the threat of insolvency is indeed beyond reasonable doubt, which FOLTF is meant to establish, there seems to be no *per se* concern about the fact that valuation drives bail-in action. Importantly, however, this does not preclude that *specific* valuation-based bail-in measures may infringe upon the right to property of individual investors/creditors.

### 3.3 Exemptions from bail-in in the public interest

A third important difference between bail-in and insolvency relates to their scope and the possibilities for exempting from their application certain (types of) creditors. The BRRD/SRMR provide for several statutory exemptions from the application of bail-in in resolution, which may violate the creditor ranking applicable in national insolvency proceedings. They include covered deposits, inter-bank loans, liabilities to payment and settlement systems as well as liabilities to employees, crucial commercial/trade creditors and tax/social security authorities.<sup>36</sup> More controversial is the empowerment of resolution authorities to exempt or partially exempt certain liabilities from bail-in on a discretionary basis.<sup>37</sup> While these case-by-case exemptions are confined to "exceptional circumstances" and must be "strictly necessary and proportionate" for the bank to continue critical functions and to avoid widespread contagion,<sup>38</sup> the resolution authority's discretion remains substantial. The required public interest largely coincides with the resolution objectives,<sup>39</sup> but is naturally subject to the appreciation of the resolution authority.<sup>40</sup>

Exempting certain creditors from loss absorption logically increases the burden for the non-exempted creditors and/or the wider public. The BRRD/SRMR stipulate that if exemptions are applied, the level of bail-in of other liabilities may be increased to compensate for such exemptions, as long as the NCWO principle<sup>41</sup> remains

<sup>34</sup> Case C-526/14, *Kotnik and others*, ECLI:EU:C:2016:570.

<sup>35</sup> Case C-526/14, *Kotnik and others*, para. 78 ("insolvency proceedings that followed such aid not being granted.").

<sup>36</sup> Article 44(2) BRRD, Article 27(3) SRMR.

<sup>37</sup> Article 44(3) BRRD, Article 27(5) SRMR.

<sup>38</sup> Article 44(3)(b) and (c) BRRD, Article 27(5)(b) and (c) SRMR.

<sup>39</sup> See Article 31(2)(a) and (b) BRRD, Article 14(2) SRMR (continuity of critical functions and maintaining financial stability).

<sup>40</sup> For the public interest test see 4 below. When exercising their discretion, authorities must also "give due consideration" to the ranking of claims in insolvency, the remaining loss-absorbing capacity of the bank and the need to secure adequate resources for resolution financing (Article 44(9) BRRD, Article 27(12) SRMR).

<sup>41</sup> See Article 34(1)(g) BRRD and Article 15(1)(g) SRMR.



respected.<sup>42</sup> According to that principle, the absolute limit of loss absorption is set at the amount that a creditor would have received had the bank undergone a normal insolvency proceeding.<sup>43</sup> That is, a non-exempted creditor may take a larger hit than if no creditors had been exempted from bail-in, but a smaller (or equal) hit than (as) under a hypothetical insolvency scenario.

Subject to certain conditions, the resolution framework thus allows for a differentiated treatment of creditors in violation of the *pari passu* principle and potentially creditor ranking applicable in insolvency. Previous cases show that it is often the differentiated application of bail-in (or loss absorption more generally) to creditors that gives rise to litigation.<sup>44</sup> Applicants may claim that the differentiated treatment was in fact based on illegitimate grounds and that a normal insolvency proceeding would have avoided such discrimination.

### 3.4 Bail-in as an interference with the right to property and its (potential) justification

The combination of the three characteristics mentioned above – bail-in as a pre-insolvency intervention, based on valuation and allowing for the preferential treatment of certain creditors to the detriment of others – render bail-in a practice that interferes with the fundamental right to property as protected by Article 17(1) CFR and Article 1 of the Protocol to the ECHR.<sup>45</sup>

While left open by the CJEU and the European Court of Human Rights (ECtHR), any kind of bail-in measure – be it the writing-down or conversion of debt, be it the cancellation or severe dilution of shares – will qualify as a deprivation of possessions under the relevant provisions.<sup>46</sup> Bail-in measures must thus observe the highest standards regarding justification and compensation.

Three conditions must be met for a deprivation of possessions to be justified:<sup>47</sup>

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<sup>42</sup> Article 44(3), last paragraph, BRRD, Article 27(5), last paragraph, SRMR.

<sup>43</sup> For the challenges in relation to the NCWO test see 5 below.

<sup>44</sup> Non-discrimination was, for example, invoked by Dutch and U.K. claimants in the Icelandic banking crisis. See Judgment of the EFTA Court, Case E-16/11, *EFTA Surveillance Authority and Commission v Iceland*, 28 January 2013. In its *HETA* ruling (VfGH 3.7.2015, G 239/2015 ua), the Austrian Constitutional Court found that the differentiated treatment of creditors within the class of subordinated creditors based on the cut-off date of their claims constituted a violation of the right to property (see Raschauer (2016) pp. 15-17). On the case of *Banco Espírito Santo/Novo Banco* (re-transfer of liabilities related to non-subordinated bonds intended for institutional investors in the amount of approximately EUR 2 billion) see *Goldman Sachs v Novo Banco* [2015] EWHC 2371 (Comm); *Guardians of New Zealand Superannuation Fund & Ors v Novo Banco SA* [2016] EWCA Civ 1092; Garcia (2016), pp. 56-57.

<sup>45</sup> In accordance with Article 52(3) CFR, the meaning and scope of Article 17(1) CFR correspond to those of the right to property guaranteed by Article 1 of the Protocol No 1 to the ECHR. Limitations to the guaranteed rights may not exceed those provided for in the ECHR. It is, however, possible for EU law to provide for further-reaching protection.

<sup>46</sup> See also Wojcik (2016), p. 119.

<sup>47</sup> See, e.g. Schabas (2015), pp. 974-979; Grabenwarter (2014), P-1 paras. 14-19; Wollenschläger (2014), paras. 17(1).38-42.

- The underlying legal basis must be sufficiently accessible, precise and foreseeable in its application.
- The interference must be in the public interest (in the terminology of the CFR: meet an objective of general interest). The ECtHR grants states a large margin of appreciation in determining what is in the public interest. Only a deprivation of possessions that is “manifestly without reasonable foundation” does not satisfy the public interest requirement.
- The principle of proportionality between the means employed and the aim pursued must be satisfied. The principle contains three elements: (i) suitability to achieve the aim pursued; (ii) necessity to achieve the aim pursued;<sup>48</sup> and (iii) proportionality in a narrow sense, i.e. a fair balance between the demands of the public interest and the individual’s fundamental rights. The CJEU applies different levels of scrutiny in its proportionality assessments.<sup>49</sup> Its more stringent version, the “least restrictive effective means test”, requires that “when there is a choice between several appropriate measures, the least onerous measure must be used (...).”<sup>50</sup>

Compensation terms are material to the proportionality of interferences with the right to property.<sup>51</sup> Deprivations of possessions “without payment of an amount reasonably related to its value”<sup>52</sup> will normally be disproportionate.

The BRRD/SRMR take account of these elements of justification in the form of two key legal safeguards: the public interest test (paragraph 4 below) and the NCWO test (paragraph 5 below). Before these safeguards are discussed in more detail, the following section highlights the difficulties associated with the calibration of bail-in in light of the proportionality requirement.

### 3.5 Proportionality in applying bail-in – or: how to calibrate bail-in?

Bail-in is designed as a last-resort measure after a cascade of other measures have not brought the bank back to viability.<sup>53</sup> It is also designed to be a measure strictly necessary to avoid the disruption of critical banking functions, maintain financial stability or pursue other objectives in the public interest.<sup>54</sup> Moreover, the

<sup>48</sup> The CFR applies a different standard than the ECHR, as interpreted by the ECtHR, which does not include a necessity requirement. Contracting States determine the necessity for an intervention under the ECHR (see Grabenwarter (2014), P1-1, para. 10).

<sup>49</sup> For an excellent account of the CJEU’s jurisprudence on proportionality see Sauter (2013). See also Wollenschläger (2014), paras. 17(1).52-54 on standard of review.

<sup>50</sup> E.g. Case 265/87, *Schröder v Hauptzollamt Gronau*, judgment, ECLI:EU:C:1989:303, para. 21.

<sup>51</sup> Compensation is not explicitly mentioned in the ECHR, but derived by the ECtHR from the principle of proportionality.

<sup>52</sup> ECtHR, *Dennis Grainger and others v the U.K.*, Application No 34940/10, judgement of 10 July 2012, para. 37.

<sup>53</sup> Including supervisory measures, measures set out in the bank’s recovery plan, potentially early intervention measures. The principle of last resort is stipulated in Article 32(1)(b) BRRD and Article 18(1)(b) SRMR.

<sup>54</sup> Article 32(1)(c) BRRD and Article 18(1)(c) SRMR. For the public interest test see 4 below.

proportionality of a bail-in measure will critically depend on the amount by which authorities write down or convert liabilities. Article 46(2) BRRD and Article 27(13) SRMR require that the amount of bail-in must enable the bank to regain “sufficient market confidence” and “to continue to meet, at least for one year, the conditions for authorisation”. Additionally, if applied on a stand-alone basis, the amount should suffice to “restore [the bank] to financial soundness and long-term viability”.<sup>55</sup>

The calibration of an appropriate (and thus proportionate) amount of bail-in represents a great operational challenge with significant legal consequences.<sup>56</sup> In *Kotnik and others*, the CJEU held that burden-sharing under State aid approval proceedings “must not exceed what is necessary to overcome the capital shortfall of the bank concerned.”<sup>57</sup> In light of the risks associated with (conjectural) valuation and uncertain market developments, authorities may have a tendency to “over-bail-in” to allow for a “safety margin” of resolution funding. After all, the need for an “after-bail-in” in case the initial bail-in turns out to be insufficient to restore the bank to full viability is arguably the less desirable scenario.<sup>58</sup>

The issue was addressed elegantly in the context of the ESM financing granted to the Cypriot banking sector in 2013. The corresponding Memorandum of Understanding (MoU) between Cyprus and the Commission/ECB provided for the immediate conversion of 37.5% of Bank of Cyprus’ (BoC) uninsured deposits into shares and for the temporary freezing of a further 22.5% of those uninsured deposits with the possibility of an “after-bail-in”. Based on an independent valuation of BoC’s assets, an additional 10% of the frozen deposits were bailed-in, bringing the total bail-in to 47.5%. Crucially, the MoU further stated that uninsured depositors would be refunded through a buy-back of shares, should Bank of Cyprus turn out to be overcapitalised relative to the Core Tier 1 (CET1) target of 9% under stress.<sup>59</sup>

In its ruling regarding the bail-in of BoC’s uninsured depositors, the CJEU appears to set the bar rather low for authorities to meet the proportionality requirement. It is regrettable that the court did not give a clearer and more comprehensive account of how it assessed the proportionality of the interference with the applicants’ right to property. Instead, the ruling confines itself to stating that the bail-in measures were *not* disproportionate:

“In view of the objective of ensuring the stability of the banking system in the euro area, and having regard to the imminent risk of financial losses to which depositors with the two banks concerned would have been exposed if the latter had failed, such measures do not constitute a disproportionate and intolerable interference impairing

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<sup>55</sup> Article 43(3) BRRD and Article 27(2) SRMR.

<sup>56</sup> See also Wojcik (2016), pp. 123-124.

<sup>57</sup> Case C-526/14, *Kotnik and others*, para. 102.

<sup>58</sup> The resolution of Banco Espírito Santo (BES)/Novo Banco is a case in point. About a year after an initial transfer, Banco de Portugal re-transferred some non-subordinated bonds back from the bridge bank (Novo Banco) to BES to compensate for an over-valuation of the assets. For more details on the case see Garcia (2016).

<sup>59</sup> See European Commission (2013), p. 42.

the very substance of the appellants' right to property. Consequently, they cannot be regarded as unjustified restrictions on that right (...)."<sup>60</sup>

Clearly, the judgement must be read in its specific context. It concerned the Union's and ECB's non-contractual liability,<sup>61</sup> requiring not just any unlawful act but "a sufficiently serious breach of a rule of law intended to confer rights on individuals".<sup>62</sup> The standard of the unlawfulness is thus elevated compared to actions for annulment. Only particularly serious illegality entails damages liability. Moreover, Cyprus was facing a collapse of its entire banking system, with the ESM programme arguably representing the only means to avoid sovereign default.

Two conclusions can nevertheless be drawn. First, the stability of the banking system constitutes an objective in the public interest that possesses much weight in the balancing with individual interests of bank creditors. And second, the court gives consideration to the hypothetical financial losses encountered in the counterfactual scenario of insolvency, provided there was an "imminent risk" of failure. Both conclusions are relevant for the analysis below.

## 4 The public interest test

The legality and legitimacy of bail-in relies heavily on the concept of public interest. A public interest test applies specifically at two stages of resolution proceedings:

- *Triggering resolution*: The BRRD/SRMR continue to declare winding-up in national insolvency proceedings the standard procedure for failing banks.<sup>63</sup> Taking resolution action, in deviation thereof, must be justified in the public interest.<sup>64</sup> Apart from identifying a bank as FOLTF<sup>65</sup> and determining that there is no reasonable prospect of any private-sector measure or supervisory action preventing the failure, the resolution authority must – as a third condition for resolution – establish that resolution action is necessary in the public interest.<sup>66</sup> It is a two-pronged test: The resolution authority must determine (i) that resolution action is necessary and proportionate to achieve at least one resolution objective and (ii) that the objective(s) could not be met to the same extent in a normal insolvency proceeding.<sup>67</sup> The second prong, the assessment of potential impacts of *not* taking resolution action, produces an obvious implementation challenge for the SRB: It must possess profound knowledge of the bank insolvency frameworks of all 28 Member States. Only with this knowledge, the SRB is able to judge the potential of resolution on the one hand

<sup>60</sup> Case C-8/15 P, *Ledra Advertising v Commission and ECB*, ECLI:EU:C2016:701, para. 74.

<sup>61</sup> Based on Articles 268 and 340 TFEU.

<sup>62</sup> Case C-8/15 P, *Ledra Advertising v Commission and ECB*, para. 65 (and judgements cited therein).

<sup>63</sup> Recital 45 BRRD, Recital 59 SRMR.

<sup>64</sup> Article 31(1)(c) and (5) BRRD, Article 18(1)(c) and (5) SRMR. No public interest test is required with regard to write-down or conversion of capital (WDCC) instruments (Articles 47, 59-62 BRRD).

<sup>65</sup> For FOLTF see 3.1 above.

<sup>66</sup> See the three conditions for resolution in Article 32(1) BRRD and Article 18(1) SRMR.

<sup>67</sup> Article 32(5) in conjunction with Article 31 BRRD, Article 18(5) in conjunction with Article 13 SRMR.

and of the default insolvency scenario on the other to achieve the public interest pursued.

- *Bail-in exemptions*: At the implementation stage, the exemption of certain (classes of) creditors from the application of bail-in according to Article 44(3) BRRD and Article 27(5) SRMR must be justified in the public interest, given that these exemptions lead to a less-favourable treatment of non-exempted creditors. The objectives that authorities may legitimately pursue with such exemptions – continuity of critical functions; maintaining financial stability; and avoiding the destruction of value – are broadly in line with the resolution objectives set out in Article 32(2) BRRD and Article 14(2) SRMR.<sup>68</sup>

## 4.1 Public interest as a (too) discretionary concept

But what exactly *is* the public interest (in the multi-layered governance of the Union)? Albeit the concept of public interest is so crucial to justifying administrative intervention, it remains one of the most discretionary areas of the resolution framework. The BRRD/SRMR benchmark the public interest test against a number of resolution objectives: (i) ensuring the continuity of critical functions;<sup>69</sup> (ii) avoiding a significant adverse effect on the financial system; (iii) protecting public funds; (iv) protecting depositors and investors; and (v) protecting client funds/assets.<sup>70</sup> These objectives, however, are many and varied and remain themselves of a “generic qualitative nature”.<sup>71</sup>

Whether or not the failure of a bank may interfere with the public interest is a question that should inform resolution authorities’ decisions and actions already at the stage of resolution planning. Only if a bank’s failure and subsequent winding-up under normal insolvency proceedings would *likely* “have a significant negative effect on financial markets, on other institutions, on funding conditions or on the wider economy” is the drafting of a fully-fledged resolution plan warranted.<sup>72</sup> The calibration of the minimum requirement for own funds and eligible liabilities (MREL) will also depend on the assessment.<sup>73</sup> The BRRD enumerates several quantitative and qualitative criteria against which banks must be assessed, including: size; interconnectedness; scope and complexity of activities; nature of business; shareholding structure; legal form; membership in an institutional protection scheme

<sup>68</sup> Article 44(3)(b)-(d) BRRD. According to Article 4(5) Commission Delegated Regulation (EU) 2016/860 of 4 February 2016 specifying further the circumstances where exclusion from the application of write-down or conversion powers is necessary under Article 44(3) of the BRRD (OJ L 144, 1.6.2016, p. 11), the decision to exclude a (class of) liabilities from bail-in must be based on at least one of the BRRD’s resolution objectives.

<sup>69</sup> “Critical functions” are defined as “activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations” (Article 2(1)(35) BRRD).

<sup>70</sup> Article 32(2) BRRD, Article 14(2) SRMR.

<sup>71</sup> Freudenthaler and Lintner (2017), p. 107.

<sup>72</sup> Article 4(1) BRRD, Article 11(3) SRMR.

<sup>73</sup> See Article 45(6) BRRD, Article 12(7) SRMR.

or other cooperative mutual solidarity system; and exercise of investment services or activities.<sup>74</sup>

However, none of this replaces the establishment of a public interest *at the point of failure*. The BRRD acknowledges the possibility that the resolution authority dismisses or identifies a public interest in resolving a bank in deviation of previous resolution planning. The effects of a bank's failure are highly dependent on the specific macroeconomic conditions in which the bank operates. Resolution planning can only indicate a bank's systemic importance at a given time. It cannot predict market developments. It remains the task of the resolution authority to assess the risks associated with a bank's failure in light of this broader context once the bank is declared FOLTF. In this risk assessment, the resolution authority is guided solely by the overarching resolution objectives. The BRRD does not refer to any indicators of public interest at the point of failure, nor does it identify circumstances under which a departure from the resolution plan could be warranted.

The courts do not add much to the substantive contour of the public interest test. It is established case law of the ECtHR that "[b]ecause of their direct knowledge of their society and its needs, the national authorities are in principle better placed than the international judge to appreciate what is 'in the public interest'."<sup>75</sup> Especially regarding social and economic policies, States are granted a wide margin of appreciation, and the court will generally respect their policy choices unless they are "manifestly without reasonable foundation"<sup>76</sup>. The ECtHR confirmed its willingness to apply a wide margin of appreciation in the case of a banking crisis in its ruling regarding the nationalisation of Northern Rock in 2008:

"The Court agrees that given the exceptional circumstances prevailing in the financial sector, both domestically and internationally, at the relevant time, a wide margin of appreciation is appropriate."<sup>77</sup>

The CJEU's standard of review regarding the legitimacy of the public interest pursued (and the consequential proportionality assessment) is similarly restricted. The margin of discretion granted to authorities is particularly wide in cases that involve "complex economic and social assessments"<sup>78</sup> or "choices of a technical nature".<sup>79</sup> The CJEU does, however, review authorities' compliance with procedural guarantees, including their obligation to give a statement of reasons for measures they take, as required by Article 296(2) TFEU.<sup>80</sup> To enable persons concerned to determine the reasons for a measure and the CJEU to exercise its power of review,

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<sup>74</sup> The criteria are further specified in the EBA Draft Regulatory Technical Standards on simplified obligations under Article 4(6) of Directive 2014/59/EU, 8 May 2017, EBA/CP/2017/05.

<sup>75</sup> ECtHR, *Dennis Grainger and others v the U.K.*, para. 36 (and rulings cited therein).

<sup>76</sup> E.g. ECtHR, *James and others v the U.K.*, Application No 8793/79, judgement of 21 February 1986, para. 46.

<sup>77</sup> *ibid.*, para. 39.

<sup>78</sup> Case C-526/14, *Kotnik and others*, para. 38 (and rulings cited therein).

<sup>79</sup> Case C-62/14, *Gauweiler and others*, judgement, ECLI:EU:C:2015:400, para. 68 (concerned a preliminary ruling).

<sup>80</sup> See *ibid.*, paras. 69-71.

authorities must state those reasons “clearly and unequivocally”, while they are not required “to go into every relevant point of fact and law.”<sup>81</sup>

This jurisprudence implies that, while authorities enjoy wide discretion in determining what is in the public interest, they must give clear account of the reasons for their decisions. It can be expected that such reasoning would include at least: (i) the assessment made in the resolution plan; (ii) any relevant developments since the last update of the plan; (iii) an assessment of the outcome of the chosen resolution scheme, if any, in light of the resolution objectives; (iv) an assessment of the outcome of an insolvency proceeding in light of the resolution objectives; (v) a comparison of the two scenarios; and (vi) an explanatory statement regarding less restrictive means. A public interest decision that deviates from the authority’s previous assessment in the resolution plan would have to meet a *higher* standard of reasoning and evidence. The decisions regarding Veneto Banca and Banca Popolare di Vicenza (BPVI), published by the SRB,<sup>82</sup> are substantiated and appear to largely observe such procedural requirement.

## 4.2 Public interest in resolution and State aid: the case of Veneto Banca/Banca Popolare di Vicenza

Nevertheless, the handling of the failure of Veneto Banca and BPVI highlights just how open the concept of public interest is to differing interpretations. On 23 June 2017, the SRB decided *not* to take resolution action in respect to the two banks for lack of public interest. It justified its assessment as follows: First, the banks performed no critical functions, because they provided services to a limited number of third parties and these services were substitutable in an acceptable and timely manner. Second, the failure would not likely lead to financial instability, given that the banks had little financial and operational interconnections with other banks. And third, normal Italian insolvency proceedings would achieve the resolution objectives to the same extent.<sup>83</sup> In contrast, the SRB had established public interest in the resolution of Banco Popular Español due to the bank’s performance of critical functions – deposit-taking from households and non-financial corporations; lending to SMEs; payment and cash services – and systemic importance just a few weeks earlier.<sup>84</sup>

While the SRB established *not enough* public interest for Veneto Banca and BPVI to enter resolution, the Commission established *enough* public interest for them to receive liquidation aid. On 25 June 2017, the Commission made public its decision to approve State aid to facilitate the liquidation of the two banks under Italian

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<sup>81</sup> *ibid.*, para. 70.

<sup>82</sup> Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A., SRB/EES/2017/11 (non-confidential version), Article 4; Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza S.p.A., SRB/EES/2017/12 (non-confidential version), Article 4.

<sup>83</sup> *ibid.*

<sup>84</sup> Decision of the Single Resolution Board in its Executive Session of 7 June 2017 concerning the adoption of a resolution scheme in respect of Banco Popular Español, S.A., SRB/EES/2017/08 (non-confidential version), Article 4.



insolvency law.<sup>85</sup> The “compulsory administrative liquidation”<sup>86</sup> of the two banks involves the transfer of some of their businesses to be integrated into Intesa Sanpaolo, while the remaining parts will be wound up in an orderly fashion. According to the burden-sharing requirement of the 2013 Banking Communication, shareholders were wiped out and subordinated creditors bailed-in prior to the grant of approximately EUR 17 billion in liquidation aid.

Where does that leave us regarding public interest? We can think of three scenarios: (i) The authorities applied the same public interest test in an inconsistent manner.<sup>87</sup> (ii) Different public interest tests apply regarding bail-in in resolution on the one hand and burden-sharing in State aid proceedings on the other. (iii) The authorities applied the same public interest test in a consistent manner, with the SRB accounting for the possibility that liquidation aid would be granted to facilitate the winding-up of the two banks.<sup>88</sup>

The Commission appears to have acted on the assumption of the second scenario, i.e. that the approval of State aid is judged against a different benchmark, as it states:

“(…), Italy has determined that the winding up of these banks has a serious impact on the real economy in the regions where they are most active. *Outside the European banking resolution framework*, Union rules foresee a possibility for Italy to seek Commission approval for the use of national funds to facilitate the liquidation by mitigating such regional economic effects.”<sup>89</sup> [emphasis added by author]

While the public interest in resolution is determined by the resolution objectives, State aid may be approved “to remedy a serious disturbance in the economy of a Member State”<sup>90</sup> based on the conditions outlined in the 2013 Banking Communication. The Commission has consistently pursued financial stability as the “overarching objective” in its assessment of State aid to the financial sector.<sup>91</sup> Liquidation aid, in particular, is meant to allow for the market exit of a failing bank “in an orderly manner so as to preserve financial stability”.<sup>92</sup> Paragraph 66 of the 2013 Banking Communication further states:

“The Commission recognises that, due to the specificities of credit institutions and *in the absence of mechanisms allowing for the resolution of credit institutions without*

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<sup>85</sup> European Commission, “State aid: Commission approves aid for market exit of Banca Popolare di Vicenza and Veneto Banca under Italian insolvency law, involving sale of some parts to Intesa Sanpaolo”, 25 June 2017, IP/17/1791.

<sup>86</sup> Liquidazione coatta amministrativa (see legislative decree no 385/1993, royal decree no 267/1942).

<sup>87</sup> The logical consequence of an identical public interest test would, however, be that liquidation aid would have ceased to exist with the entering into force of the BRRD.

<sup>88</sup> The SRB’s decisions on Veneto Banca and BPVI refer solely to the possibility of a DGS-assisted transfer of assets and liabilities.

<sup>89</sup> European Commission, “State aid: Commission approves aid for market exit of Banca Popolare di Vicenza and Veneto Banca under Italian insolvency law, involving sale of some parts to Intesa Sanpaolo”, 25 June 2017, IP/17/1791.

<sup>90</sup> Article 107(3)(b) TFEU. See also 2013 Banking Communication, para. 15.

<sup>91</sup> 2013 Banking Communication, paras. 7-11.

<sup>92</sup> *ibid.*, para. 65.



*threatening financial stability*, it might not be feasible to liquidate a credit institution under ordinary insolvency proceedings. For that reason, State measures to support the liquidation of failing credit institutions may be considered as compatible aid, subject to compliance with the requirement specified in point 44 [burden-sharing requirement].” [emphasis added by author]

With the entering into force of the BRRD/SRMR, there is no longer an absence of a mechanism allowing for the resolution of banks without threatening financial stability. In fact, under this framework, it is the task of the resolution authority – national or European – to determine whether liquidating a bank under ordinary insolvency proceedings threatens financial stability or not.

Can other factors play into the Commission’s assessment of a “serious disturbance in the economy”? The Commission has not formally distanced itself from the self-restraints set out in the 2013 Banking Communication regarding liquidation aid. Article 107(3)(b) TFEU *per se* would appear to be open to a legal interpretation that extends beyond the concept of financial stability. Italy perceived the aid necessary to avoid an economic disturbance in the Veneto region following the liquidation of BPVI and Veneto Banca. In the introduction of a decree submitted to the Italian Parliament regarding their “special insolvency proceeding” it says that liquidating the two banks would destroy value, cause serious losses for retail unsecured creditors and break up credit relationships with businesses and families.<sup>93</sup> Little is known yet about the reasons for the Commission’s endorsement of a public interest. However, if the Commission decided to apply a broadened public interest test in deviation of its previous practice and communication, it too would have to meet a *high* standard of reasoning and evidence.<sup>94</sup> This is particularly true given that such change of practice would introduce a public interest test that is inconsistent, in substance, with the test applied by resolution authorities based on the BRRD/SRMR.

From what is known at the time of writing, the public interest identified by the Italian authorities does not appear to deviate much, in substance, from the resolution objectives set out in the BRRD/SRMR. What clearly differs, however, is procedure. Resolution and State aid proceedings provide reverse roles for Member States in the banking union. Whether or not resolving a bank is in the public interest is determined by the Executive Session of the SRB in the interest of the Union as a whole.<sup>95</sup> In contrast, ownership of the procedure in State aid proceedings rests with the Member States. They are the initiators of such proceeding and provide the necessary information and data to back their determination of a public interest. Based on Member States’ (non-binding) input, the Commission endorses or rejects.

<sup>93</sup> Decreto-legge 25 giugno 2017, n. 99, Disposizioni urgenti per la liquidazione coatta amministrativa di Banca Popolare di Vicenza S.p.A. e di Veneto Banca S.p.A. (“in assenza di misure pubbliche di sostegno, la sottoposizione delle Banche a liquidazione coatta amministrativa potrebbe comportare una distruzione del valore delle aziende bancarie coinvolte, con conseguenti gravi perdite per gli operatori non professionali creditori chirografari, che non sono protetti né preferiti, e imporrebbe un’improvvisa cessazione dei rapporti di affidamento creditizio per imprese e famiglie, con conseguenti forti ripercussioni negative sul tessuto produttivo e sociale nonché occupazionali.”). See also European Parliament, Briefing – The orderly liquidation of Veneto Banca and Banca popolare di Vicenza, 25 July 2017, pp. 5-6.

<sup>94</sup> See 4.1 above.

<sup>95</sup> The SRB’s determination is subject to Commission/Council endorsement (Article 18(7) and (8) SRMR).

Accordingly, the State aid framework may be more flexible to include economic disturbances with an impact confined to the regional or even local level.

From all of this we can conclude that, currently, a European and a national public interest test co-exist. In the case of Veneto Banca and BPVI, their co-existence resulted in senior creditors and depositors being bailed-out instead of bailed-in. They likely ended up better off in liquidation than in resolution – a scenario that is at odds with the very objectives that led to the adoption of the BRRD/SRMR.<sup>96</sup> Bail-in in resolution and “burden-sharing” in State aid proceedings are functionally equivalent practices. There is no convincing reason why a different public interest test *should* apply. However, while aligning the European and national public interest tests is necessary, it remains challenging as long as bank insolvency (in contrast to resolution) stays within the remit of Member States.

## 5 The NCWO test

The second key legal safeguard of the BRRD concerns proportionality.<sup>97</sup> The NCWO test is designed to limit the extent to which bail-in may interfere with the right to property.<sup>98</sup> Bail-in should not inflict greater losses on shareholders and creditors than the losses they would have incurred had the bank instead been wound up in a normal insolvency proceeding. Article 34(1)(g) BRRD and Article 15(1)(g) SRMR establish the NCWO principle as a general principle governing resolution. If resolution action infringes the principle, shareholders and creditors are entitled to compensation.<sup>99</sup>

As a rule, resolution that allows for preserving the franchise value of a bank will produce smaller *total* losses than liquidation based on gone concern. The experience with pre-BRRD bail-in cases confirms this: In the Austrian *HETA* case, valuation estimated a 34% recovery rate in a hypothetical insolvency scenario, compared to an estimated 46% recovery rate under resolution. And the hypothetical insolvency losses (valuation 3: DKK –142.7 million) were assumed to be about 50% higher than the losses under resolution (valuation 2: DKK –96.4 million) in the *Andelskassen* case in Denmark.<sup>100</sup> The NCWO test will be of particular relevance where the exemption of certain debt or classes of debt from the application of bail-in shifts a bank's losses to other (potentially higher-ranking) creditors. These creditors are prone to incur losses exceeding those resulting from a hypothetical insolvency proceeding.

<sup>96</sup> See EBA, The “banking reform package”: CRD 5/CRR 2/BRRD 2, Andrea Enria hearing at the Italian Senate, 5 July 2017 (English translation), p. 6.

<sup>97</sup> It also aims to counterbalance the restricted *ex-ante* judicial review of bail-in decisions (Article 85 BRRD). See also Wojcik (2015), p. 255; Athanassiou (2014), p. 16.

<sup>98</sup> Wojcik (2015), p. 256.

<sup>99</sup> Article 75 BRRD.

<sup>100</sup> Numbers taken from Merc (2017), p. 141. In the latter case, while some creditors received compensation under the NCWO principle, no litigation proceedings were initiated by shareholders or creditors whose claims were bailed-in (see Andersen, Lintner and Schroeder (2016), pp. 27-28).

## 5.1 Does NCWO protect from the protection of the right to property?

Even prior to the entering into force of the BRRD, the Commission had introduced a NCWO test in its State aid proceedings. The Banking Communication 2013 states:

“In the context of implementing points 43 and 44 [the burden-sharing requirement], the ‘no creditor worse off principle’ should be adhered to. Thus, subordinated creditors should not receive less in economic terms than what their instrument would have been worth if no State aid were to be granted.”<sup>101</sup>

In *Kotnik and others*,<sup>102</sup> the CJEU concluded that based on this provision:

“(…) the burden-sharing measures on which the grant of State aid (…) is dependent cannot cause any detriment to the right to property of subordinated creditors that those creditors would not have suffered within insolvency proceedings that followed such aid not being granted.”<sup>103</sup>

A narrow reading of this paragraph may suggest that the stipulated NCWO test precludes as a matter of legal principle that burden-sharing as a precondition for granting State aid may affect investors’ right to property. Arguably, however, the CJEU just repeats in its own words what the NCWO test *seeks to achieve*, i.e. to cause no detriment to the right to property of investors. According to such reading, the burden-sharing requirement set out in the 2013 Banking Communication can be applied in a way that is compatible with fundamental rights, with the NCWO test constituting a key legal safeguard. As Advocate General Wahl put it: the NCWO test “require[s] Member States to give due consideration to the property rights of the investors when restructuring a bank in distress.”<sup>104</sup>

The conclusions we can draw from the ruling regarding the application of bail-in under the framework of the BRRD/SRMR are rather limited. *Kotnik and others* represents a preliminary ruling on the validity and interpretation of the Commission’s 2013 Banking Communication. It does not, however, evaluate a specific case where burden-sharing or, to that effect, bail-in was applied. Advocate General Wahl states the obvious when he argues that

“the fact that points 40 to 46 of the 2013 Banking Communication do not automatically lead to any breach of those rights does not imply that burden-sharing measures actually adopted by a Member State which comply with that communication are necessarily compatible with those rights.”<sup>105</sup>

While the NCWO test contributes to the compatibility of the 2013 Banking Communication and, to that effect, the BRRD/SRMR with the right to property *in*

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<sup>101</sup> Banking Communication 2013, para. 46.

<sup>102</sup> Case C-8/15 P, *Ledra Advertising v Commission and ECB* does not refer to the NCWO test.

<sup>103</sup> Case C-526/14, *Kotnik and others*, para. 78.

<sup>104</sup> Opinion of Advocate General Wahl in Case C-526/14, *Kotnik and others*, ECLI:EU:C:2016:102, para. 73.

<sup>105</sup> *ibid.*, para. 75.

*principle*, the judgement (unlike the opinion of the Advocate General<sup>106</sup>) remains silent regarding such compatibility of *specific measures* applied by resolution authorities. After all, NCWO is a principle guiding the decisions and actions of authorities, not a condition or status. It does not suffice to preclude *a priori* that bail-in measures may, in reality, affect the right to property.<sup>107</sup>

Moreover, the burden-sharing requirement under the State aid framework is confined to shareholders and subordinated creditors. Unlike in resolution, senior creditors are explicitly excluded from contributing to loss absorption.<sup>108</sup> The bail-in of senior creditors, including uninsured depositors, however, may raise additional concerns and require a somewhat different legal assessment.

## 5.2 NCWO as an assumption-based valuation exercise

The NCWO test is essentially a *valuation exercise* and thus conjectural in its nature. Article 74 BRRD stipulates that an independent valuer carry out a valuation after the application of a bail-in. This valuation establishes the difference in treatment of shareholders and creditors in resolution and in a hypothetical insolvency proceeding. If the difference turns out to be negative, affected shareholders and creditors are entitled to seek compensation directly from the national resolution financing arrangement or the Single Resolution Fund, respectively.<sup>109</sup> The valuation shall take place “as soon as possible” after resolution starts, with no explicit end-date.<sup>110</sup> In practice, it will likely take several months, if not years.<sup>111</sup> The details of the valuation methodology are delegated to the Commission for further determination in a delegated regulation.<sup>112</sup>

The NCWO test is based on three main assumptions: (i) that the bank under resolution had instead entered normal insolvency proceedings at the time resolution was triggered; (ii) that the resolution had not taken place; and (iii) that the bank under resolution had received no extraordinary public financial support.<sup>113</sup> Assumption 1 and 3 are particularly controversial.

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<sup>106</sup> *ibid.*, paras. 85-91.

<sup>107</sup> See also Micossi, Bruzzone and Cassella (2016), p. 15.

<sup>108</sup> 2013 Banking Communication, para. 42.

<sup>109</sup> Article 43(3) third paragraph and Article 75 BRRD, Article 76(1)(e) SRMR.

<sup>110</sup> Article 74(1) BRRD.

<sup>111</sup> Freudenthaler and Lintner (2017), p. 106.

<sup>112</sup> See Regulatory Technical Standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under Directive 2014/59/EU on recovery and resolution of credit institutions and investment firms (final draft), 23 May 2017, EBA/RTS/2017/05 and 06 (not yet endorsed by the Commission at the time of writing). For an early account of the methodological difficulties see Athanassiou (2014). See also Hadjiemmanuil (2015), p. 244-245.

<sup>113</sup> Article 74(3) BRRD.

### 5.2.1 Assumption 1: normal insolvency proceeding

Assumption 1 is that a failing bank – instead of resolution – undergoes a normal insolvency proceeding. But what is a “normal insolvency proceeding” in the Union?<sup>114</sup> Lacking Union-wide harmonisation of bank insolvency, the comparator of a normal insolvency proceeding can only mean the specific national insolvency regime(s) applicable to the bank at hand.<sup>115</sup> If the comparator of the NCWO test is based on different procedures and objectives set out in the applicable insolvency law and on the insolvency practice of each Member State,<sup>116</sup> the test will necessarily produce different outcomes across borders. Creditors may be entitled to different amounts of compensation under the NCWO test depending on the Member State in which the resolution proceeding takes place.

While the assumption refers to national law and practice, it does not embrace *any* national practice as a “normal insolvency proceeding” under the NCWO test. Valuation 3 must be conducted on a gone-concern basis.<sup>117</sup> This would exclude the (partial) restructuring of a failing bank on a going-concern or open-bank basis as a potential counterfactual scenario to resolution, such as the transfer of assets and liabilities to a purchaser in case of insolvency.

Yet, the insolvency proceeding of Veneto Banca and BPVI is exactly such a case. The Italian authorities essentially applied the sale-of-business tool outside of resolution, as it is provided for by the Italian compulsory administrative liquidation (CAL) regime. In its assessment of the public interest in the banks’ resolution, the SRB explicitly refers to the possibility of a sale-of-business transaction under Italian insolvency law:

“Since normal insolvency proceedings (i.e. CAL) allow for the transfer to a purchaser of the same portfolio which could have been transferred in case of resolution action, it can be concluded that CAL proceedings could meet these two resolution objectives [protecting depositors/investors and protecting client assets/funds] to the same extent.”<sup>118</sup>

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<sup>114</sup> According to Article 2(1)(47) BRRD, “normal insolvency proceeding” refers to a collective proceeding, “which entail[s] the partial or total divestment of a debtor and the appointment of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person”.

<sup>115</sup> According to Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (OJ L 125, 5.5.2001, p. 15), this will be the law of the bank’s home Member State (Article 10). However, in addition, other legal regimes may be applicable to specific aspects of the insolvency proceeding (e.g. Articles 20-33).

<sup>116</sup> According to the Regulatory Technical Standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under Directive 2014/59/EU on recovery and resolution of credit institutions and investment firms (final draft), 23 May 2017, EBA/RTS/2017/05 and 06, the valuer shall take into account the “applicable insolvency law and usual insolvency practice in the relevant jurisdiction” as well as “the information on recent past insolvency cases of similar entities, where available and relevant” (Article 4(3)(a) and (c) Final draft RTS on valuation after resolution).

<sup>117</sup> For more details see Final draft RTS on valuation after resolution, *ibid*.

<sup>118</sup> Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A., para. 51; Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza S.p.A., para. 51.

Do we apply different counterfactual scenarios under the public interest test on the one hand and the NCWO test on the other? Is open-bank restructuring a legitimate counterfactual scenario for determining whether resolution is warranted in the public interest, but an illegitimate counterfactual scenario for establishing creditors' right to compensation under the NCWO test? The fact is that the assumption of what constitutes a "normal insolvency proceeding" does not necessarily conform with actual practice.

### 5.2.2 Assumption 3: no extraordinary public financial support

Assumption 3 is that the failing bank receives no extraordinary public financial support. Relevant case law seems to support this assumption. In *Kotnik and others*, the CJEU ruled that there is no legitimate expectation for a bank to receive State aid.<sup>119</sup> The ECtHR held in *Grainger and others* that the nationalisation of Northern Rock based on a valuation that ignored the Lender of Last Resort (LOLR) assistance provided to the bank by the Bank of England is legitimate.

"In the Court's view, the decision taken in the legislation that the former shareholders of Northern Rock should not be entitled to take the value which had been created by the Bank of England's loan was far from being 'manifestly without reasonable foundation'. Instead, it was clearly founded on the policy of avoiding 'moral hazard', which is at the heart of the principles which regulate the provision of LOLR."<sup>120</sup>

Both judgements concerned shareholders (*Grainger*) and subordinated creditors (*Kotnik*), not depositors. The question remains as to what uninsured depositors can legitimately expect.

The NCWO test treats all stakeholders of a bank equally. Both investors and uninsured depositors are entitled to the *liquidation value* of their claims. However, there is a difference between investments and deposits that may warrant a differentiated legal standard. According to the case law of the CJEU, the loss of profit does not give rise to compensation claims under the right to property.<sup>121</sup> The court makes this very clear in *Kotnik and others*, stating that "in accordance with the general rules applicable to the status of shareholders of public limited liability companies, they must fully bear the risk of their investments."<sup>122</sup> Therefore, they "are liable for the debts of the bank up to the amount of its share capital (...)."<sup>123</sup> Regarding subordinated creditors, the CJEU holds that their claims are constituted by financial instruments of a hybrid nature, "which share certain characteristics with debt products and certain characteristics with shares in equity capital."<sup>124</sup> With their

<sup>119</sup> Case C-526/14, *Kotnik and others*, paras. 61-69. The ruling was based on the NCWO test applied by the Commission in its State aid approval proceedings (see 2013 Banking Communication, para. 46).

<sup>120</sup> ECtHR, *Dennis Grainger and others v the U.K.*, para. 42.

<sup>121</sup> E.g. Case C-283/11, *Sky Österreich*, ECLI:EU:C:2013:28, para. 34 ("opportunities, the uncertainties of which are part of the very essence of economic activity"); Case C-295/03, *Alesandrini and others v Commission*, ECLI:EU:C:2005:413, paras. 88 and 89. See also von Bonin and Olthoff (2016), p. 780.

<sup>122</sup> Case C-526/14, *Kotnik and others*, para. 73.

<sup>123</sup> *ibid.*, para. 74.

<sup>124</sup> *ibid.*, paras. 27 and 76.

subordination to the holders of ordinary debt in the event of the bank's insolvency or winding-up, subordinated creditors assume a financial risk for which they are remunerated by a higher rate of return.<sup>125</sup> Hence, their qualification as investors.

The bail-in of depositors, in contrast, does *not* realise an investment risk. Depositors do not pay money to the bank now to get more later. They are interested in liquidity and/or having their savings stored safely. Deposits – both insured and uninsured – will generally not qualify as investments within the meaning of the CJEU's jurisprudence. Moreover, the moral hazard argument that both the CJEU<sup>126</sup> and the ECtHR<sup>127</sup> invoke regarding shareholders and subordinated creditors applies to a lesser extent to depositors. Retail depositors, in particular, will often not be in a position to monitor and curtail the risk-taking of "their" bank, independent of whether or not their funds are subject to loss absorption.<sup>128</sup>

These considerations have led to measures being taken to protect (retail) depositors from having to absorb major losses in case a bank fails. The BRRD provides that uninsured depositors rank higher in bank insolvency and resolution than other unsecured creditors.<sup>129</sup> Moreover, the Commission proposes a new class of non-preferred senior debt instruments that would be bailed-in before uninsured retail depositors.<sup>130</sup> Against this background, it does not come as a big surprise that the possibility to provide liquidation aid to failing banks with a large retail depositor base has not been given up (yet). This raises the question, however, whether a normal insolvency proceeding with no extraordinary public financial support truly remains a credible counterfactual scenario with respect to (retail) depositors. Or does a legitimate expectation to liquidation aid in certain circumstances after all exist?

## 6 Conclusions

The Union has come far in its efforts to maintain financial stability, while shielding taxpayers from the cost of bank failures. Bail-in enables authorities to meet both objectives at the same time. It comes, however, with its own challenges. Designed as a pre-insolvency, valuation-based intervention by administrative authorities that allows for discretionary exemptions from loss absorption, bail-in differs from its prototype – insolvency – in several crucial ways. Bail-in measures interfere with shareholders' and creditors' fundamental right to property as guaranteed by the CFR and the ECHR and must be validly justified.

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<sup>125</sup> *ibid.*, para. 27.

<sup>126</sup> Case C-526/14, *Kotnik and others*, para. 58.

<sup>127</sup> ECtHR, *Dennis Grainger and others v the U.K.*, para. 42.

<sup>128</sup> See also Avgouleas and Goodhart (2015), p. 17.

<sup>129</sup> Article 108(a) BRRD.

<sup>130</sup> See Proposal for a Directive of the European Parliament and of the Council on amending Directive 2014/59/EU of the European Parliament and of the Council as regards the ranking of unsecured debt instruments in insolvency hierarchy, 23.11.2016, COM(2016) 853 final. For the challenges of creditor ranking in resolution and insolvency, see the contribution of David Ramos Muñoz, entitled "Bank resolution and insolvency ranking and priorities", in this book.



This contribution took a closer look at two legal safeguards of the BRRD/SRMR aimed at ensuring that bail-in measures are compatible with the right to property: the public interest test and the NCWO test. While both safeguards are indispensable to the effectiveness of bail-in and resolution more generally, the devil is in the details. The aim of this contribution was to emphasise potential contradictions and future uncertainties in the application of these safeguards in light of recent developments.

With the public interest test, resolution authorities determine whether resolution and bail-in action is necessary or the default scenario of an insolvency proceeding according to national law sufficient to achieve a number of targeted objectives in the public interest. While the public interest is a discretionary concept, this contribution highlighted the importance of consistency in the application of the test. With its State aid decision in the case Veneto Banca/BPVI, the Commission (re-)introduced an intermediate regime between resolution and insolvency: insolvency with liquidation aid. This intermediate regime applies if there is not enough public interest in resolution (determined by the SRB, subject to Commission endorsement), but too much public interest for the bank to be liquidated without public financial support (endorsed by the Commission based on Member State application). The law may be open to an interpretation that justifies the continuing provision of liquidation aid to failing banks, even after the adoption of the BRRD/SRMR. From a legal policy perspective, however, the (remaining) *raison d'être* of such aid is much less evident.

The NCWO test is designed to give resolution authorities a benchmark regarding the proportionality of bail-in measures. While conclusive case law is still lacking, the test goes a long way towards limiting bail-in to a proportionate extent. Difficulties arise from its conjectural nature. The assumptions that the NCWO test is based upon may be prone to challenge, as they deviate from actual practice. Practice creates expectations and expectations may have legal implications. In light of the many uncertainties surrounding the interpretation and application of the new resolution regime and the continuing work on BRRD2, it is too early to expect a settled practice. What can be expected, though, is that authorities give clear account of the reasons underlying their decisions. This will help develop a consistent and coherent body of case law and sort out what really are legitimate expectations in banking.

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## Seraina Grünewald

Seraina Grünewald is an assistant professor of financial market law at the University of Zurich, Switzerland.

Prior to her appointment at the University of Zurich she worked as a senior lecturer at the University of Liechtenstein and was a trainee in the Directorate General Legal Services of the European Central Bank. Ms Grünewald spent a total of almost three years as a visiting scholar at Columbia, Yale and Harvard Law Schools and participated in the International Monetary Fund's distinguished Internship Program, where she conducted research on the resolution of cross-border banks and potential burden-sharing arrangements.

She holds a JSD (Dr. iur.) from the University of Zurich, Bachelor's and Master's degrees in law from the University of Bern, and is admitted to the Swiss bar.

She is the author of one of the very first monographs on cross-border bank resolution and burden sharing in the European Union, published by Kluwer Law International in early 2014, and a number of scholarly articles in the field.

